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No. 80-264

In the Supreme Court of the United States

OCTOBER TERM, 1980

ELMER B. STAATS, COMPTROLLER GENERAL
OF THE UNITED STATES,
AND
UNITED STATES OF AMERICA, PETITIONERS

v.

BRISTOL LABORATORIES DIVISION OF
BRISTOL-MYERS COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY MEMORANDUM FOR THE PETITIONERS

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1. Respondent does not contest the importance of a uniform interpretation of the statutory access-to-records provisions to the proper administration of the federal procurement system. Nor does respondent dispute that divergent constructions of these provisions by the courts of appeals would warrant this Court's review. See Pet. 9. Respondent does assert, however, that the decision below has not created a conflict among the circuits because, in its view, the courts' holdings can be reconciled in terms of the different facts presented in each case. Respondent contends that these differences in outcome turn not on disagreements over the governing legal principles but rather on the application of those principles to the distinct factual records under consideration.

Respondent's reading of these cases is unfounded. As discussed in the petition (Pet. 8-9 & n.9), there is a clear conflict in the circuits concerning the construction of the access-to-records provisions.[1] Indeed, contrary to respondent's argument, the courts of appeals themselves have expressly recognized the existence of this conflict (see Pet. 8); as the Second Circuit observed in adopting the opinion of the district court in this case, the Seventh Circuit's decisions in *United States* v. *Abbott Laboratories*, 597 F. 2d 672 (1979), and *Eli Lilly & Co.* v. *Staats*, 574 F. 2d 904, cert. denied, 439 U.S. 959 (1978), "reject the holding of the * * * [district court], but we do not find their reasoning persuasive" (Pet. App. 3a).[2]

Moreover, the facts in this case and in *Eli Lilly* do not differ in any material regards.[3] Both of these cases involve

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[1]See also Br. in Opp. 6 n.4, *SmithKline Corp.* v. *Staats*, conditional petition for cert. before judgment pending, No. 80-434 (filed Sept. 18, 1980). We are providing respondent with a copy of our brief in opposition in *SmithKline*.

[2]Respondent attempted in the court of appeals to distinguish *Eli Lilly* on the same factual grounds it advances here (Bristol Br. 16-19), but the Second Circuit declined to adopt this argument, concluding instead that its decision and *Eli Lilly* were squarely in conflict (Pet. App. 3a).

[3]An affidavit filed in the district court in this case, which was not challenged by respondent, stated GAO's understanding (1) that the several pharmaceutical companies in question, including respondent, utilized substantially similar cost accounting systems that only assigned certain manufacturing costs to individual products but treated all other costs on an unallocated basis, and (2) that the companies recovered their costs, both allocated and unallocated, from general revenues that included payments by the government under the contracts at issue (C.A. App. 106-107). See also *United States* v. *Abbott Laboratories*, *supra*, 597 F. 2d at 673-674, 675; *SmithKline Corp.* v. *Staats*, 483 F. Supp. 712, 715, 720, 721 n.7, 722 (E.D. Pa. 1980), appeal pending, No. 80-1464 (3d Cir., filed Mar. 19, 1980), conditional petition for cert. before judgment pending, No. 80-

negotiated fixed-price contracts for the sale of pharmaceutical products (see Pet. 3-4; 574 F. 2d at 907, 920, 925). In each of the cases the price charged the government was based on the company's standard price for its commercial customers, and there was no discussion of costs at the time the contracts were executed (see Pet. 12 n.14; 574 F. 2d at 906, 907, 914, 920, 923, 925). Neither of the contractors allocated, on either a product or a customer basis, many of the costs that were the subject of the Comptroller General's request for access to records, and neither of them purported to have directly or specifically considered these costs in setting their prices (see Pet. 5-6, 12 & n.13; 574 F. 2d at 914, 920, 925).[4] In both cases the revenues derived from the government contracts were used, as part of commingled general revenues, to defray all costs and expenses, including the unallocated costs reflected in the records sought by GAO (see Pet. 6-7, 12; C.A. App. 160a-165a, 168a-169a; *Eli*

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434 (filed Sept. 18, 1980); *Merck & Co.* v. *Staats*, Civil Action No. 74-1447 (D.D.C. Aug. 12, 1977), slip op. 1-3, appeals pending, Nos. 79-1435, 79-1438 (D.C. Cir., argued Feb. 11, 1980), conditional petition for cert. before judgment pending, No. 80-416 (filed Sept. 16, 1980); cf. *Hewlett-Packard Co.* v. *United States*, 385 F. 2d 1013, 1014, 1016 (9th Cir. 1967), cert. denied, 390 U.S. 988 (1968).

[4]Respondent characterizes (Br. in Opp. 7) the *Eli Lilly* holding as resting on the court's finding "that as a matter of fact the research and development costs involved in that case 'at the least appear to have a logical, causal and consequential relationship to a portion of the price of the products purchased by the Government' " (quoting 574 F. 2d at 914). We submit that respondent has misconstrued the court's reasoning in *Eli Lilly*. The Seventh Circuit's opinion makes evident that the above-quoted passage refers not to the particular facts of record in that case but rather to "[t]he [m]eaning of the [s]tatutes * * * as applied to the pharmaceutical industry * * *" (574 F. 2d at 913). The court's legal analysis of the access-to-records provisions and its application of those provisions based on the nature of the pharmaceutical industry are equally apposite to the case at bar.

Lilly & Co. v. *Staats*, *supra*).[5] Finally, GAO's requests for access to the specified records of the pharmaceutical companies were identical in each case (see Pet. 4, 8; 574 F. 2d at 906).

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[5]The depositions of company officials made clear that Eli Lilly, like respondent, recovered all of its costs, including its unallocated costs, from commingled general revenues that consisted in part of payments by the government:

Q. [government attorney] * * * So, is it correct to assume that Lilly, as a profitable company, recovers all of its costs through the sale or revenues derived from the sale of its products?

A. [Eugene L. Step, President, Pharmaceutical Division, Eli Lilly & Co.] Sure. I think that the financial statements are very specific testimony to that fact.

Q. Quite impressive, as a matter of fact.

Well, from that, then, would you conclude that your research and development costs, your general and administrative costs, your marketing costs, and your manufacturing costs are recovered through the sale, revenues derived from the sale of the pharmaceutical products?

A. I think that's fair. All costs of doing business are recovered from the sale, from the revenues derived from the sale of all of our products. That includes our pharmaceutical products, our agricultural products, our cosmetics, certain packaging products we sell.

* * * * *

A. * * * I view the Federal Government as a customer like any other. * * *

In other words, it is of no more interest to me what the standard cost of a product is in quoting to the Federal Government than it is in putting it in the price list. I'm not there to turn over dollars. I'm not there to recover standard costs in sales to the Federal Government. I'm there to earn a profit on those sales, and if we're down to a price that's so close to standard that the question is recovering costs, we won't bid. I'm not interested in that business. We'll let some of our competitors have that.

Q. I think I understand what you're saying. So, that if a situation should develop that the price quoted to the Government would

On these common facts, the Seventh Circuit has sustained the Comptroller General's authority to inspect the designated records of unallocated costs; the Second

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Q.—Continued:

recover only your standard costs or close, that is not the kind of business that you would be interested in capturing?

A. That's right.

* * * * *

Q. If your quoted price in the situation that we have just discussed would recover only your manufacuturing costs, or slightly in excess of it, isn't it fair to say that you wouldn't be interested in that business because such a price wouldn't recover your other costs?—your research and development cost, your general and administration cost, your marketing cost.

A. Well, you're getting there. You are getting to a kind of a convoluted way of what I'm really saying, is that we follow the prices. We have people who follow the prices at which the Government lets tenders, or on which the Government awards tenders. If the Government wants to buy penicillin VK; they put out a tender. The results of those are advertised, so we know what the going market is. If that going market is attractive to us, we would bid. If the going market is not attractive to us, we wouldn't bid.

* * * * *

Q. Are the revenues derived from sales to the Government placed in any special bank account?

A. [Deane Pinney, Administrator for the Financial Reporting, Eli Lilly & Co.] No.

Q. Are they commingled with other revenues?

A. Yes.

Q. Are revenues then derived from the sale of the company's products, including revenues derived from sales to the Government, used to recover the costs of those sales?

A. Yes.

C.A. App. 161a, 163a-164a, 165a, 169a, *Eli Lilly & Co.* v. *Staats*, *supra*.

Circuit has reached exactly the opposite conclusion and prohibited the requested inspection.[6] Thus, there is an unavoidable conflict that should be resolved by this Court.[7]

2. Respondent also briefly adverts (Br. in Opp. 9) to the merits of the issue presented in this case and contends that the decision below is consistent with the legislative history of the access-to-records statutes. In agreement with our position (Pet. 10-13),[8] respondent concedes (Br. in Opp. 9) that the purpose of the statutes "was to empower the Comptroller General to audit governmental contracts' costs and performance *to the end that the government be guarded against excessive cost or waste*" (emphasis added).[9] Especially in the pharmaceutical

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[6]Respondent quotes at some length (Br. in Opp. 3 nn.6, 7) from the district court's opinion initially denying cross-motions for summary judgment on the ground that the record did not adequately reveal respondent's "methods of accounting and allocation of costs" (C.A. App. 22). At the present stage, however, these factual uncertainties have been clarified, summary judgment has been entered against the government, and the petition raises a legal issue that does not depend on any outstanding factual disputes between the parties (see Pet. App. 6a n.1).

[7]Contrary to respondent's suggestion (Br. in Opp. 8), the fact that *Abbott* was decided on grounds of *stare decisis* in light of the decision by the same circuit court of appeals in *Eli Lilly* emphasizes rather than negates or minimizes the existence of a conflict between the Second and Seventh Circuits. We also note that the Seventh Circuit denied a petition for rehearing en banc in *Eli Lilly* (see 574 F. 2d 904).

[8]See also Comment, *The Comptroller General's Authority to Examine the Private Business Records of Government Contractors: Eli Lilly & Co.* v. *Staats*, 92 Harv. L. Rev. 1148, 1157-1158 & nn.67-68 (1979).

[9]Respondent has not addressed our further arguments (Pet. 14-17) that, because GAO's longstanding and consistent construction of the access-to-records provisions is reasonable and has not been

industry, where the direct costs of manufacturing and delivering individual products constitute as little as 9% of the sales price and manufacturers devote approximately 12% of sales revenues to unallocated research and development costs (see Pet. 13), the access-to-records provisions would afford a wholly inadequate protection against waste, excessive prices, and ineffective procurement if it is held, as the court below did, that the statutes do not extend to the companies' substantial unallocated costs pertaining to research and development, advertising and promotion, distribution, and administration. Rather, because Congress intended the Comptroller General to have "the proper tools to do the job the Congress has instructed him to do" (97 Cong. Rec. 13198 (1951) (remarks of Rep. Hardy)) and sought to enable him to determine whether the contract price was "extravagan[t]," "excessive," or "wasteful[]" (*ibid.*), we submit that the access-to-records provisions are applicable to the records of unallocated costs that have been requested by GAO in this case.[10]

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overturned by Congress, the court below erred in rejecting the interpretation of the statutes adopted by the agency charged with the responsibility for their administration.

[10]Respondent contends (Br. in Opp. 9; see also *id.* at 7-8 n.14) that the exclusion of its unallocated costs from consideration by GAO would necessarily work to the company's disadvantage in assessing the reasonableness of the contract price to the government. However, respondent does not assert that it priced its products on the basis of partial or incremental costs and, since the government was charged respondent's normal wholesale price (see Pet. 12 n.14), any contention that the contract price could be reasonable without regard to significant unallocated costs, such as research and development, is specious. At all events, respondent's position, even if correct in terms of the reasonableness of a specific contract, focuses solely on GAO's function to determine whether the individual "contract may have been an inappropriate means of meeting this

For the foregoing reasons and the reasons stated in the petition, it is therefore respectfully submitted that the petition for a writ of certiorari should be granted.

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particular procurement need of the Government" and ignores its responsibility to study and recommend "the use of other methods of meeting future procurement needs." *Hewlett-Packard Co.* v. *United States*, *supra*, 385 F. 2d at 1016.

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